IT 96-35
Tax Type: INCOME TAX
Issue: Business/Non-Business (General)
Unitary Apportionment

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	)	
Petitioner	)	**No.**
v.	)	**FEIN:**
TAXPAYER	)	
Taxpayer	)	**Linda K. Cliffel, Admin. Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Helen E. Witt of Kirkland & Ellis, for TAXPAYER; Wendy Paul, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

The instant case arose as a result of three audits conducted by the Illinois Department of Revenue (hereinafter referred to as the "Department") of TAXPAYER (hereinafter referred to as "TAXPAYER" or "Taxpayer") for the years ended 12/31/83 and 12/31/84; 12/31/85 and 12/31/86; and 12/31/87 and 12/31/88. The audits relate to a review conducted by the Department of TAXPAYER' tax returns filed under the Illinois Income Tax Act. 35 ILCS 5/101 et seq.

Notices of Deficiency were issued to TAXPAYER on February 15, 1990 for the year ended 12/31/85 (1985-1986 audit cycle) in the amount of $70,654 and on November 8, 1990 for the years ended 12/31/87 and 12/31/88 in the amount of $92,116.

The main issue common to all three audits was the Department's reclassification of interest income earned from a loan by TAXPAYER to its

foreign subsidiary, SUBSIDIARY (hereinafter referred to as "SUBSIDIARY"), from nonbusiness income to business income pursuant to 86 Ill. Admin. Code ch. I, Sec. 100.3010(d)(4)[1].

Taxpayer disagreed with the disallowance and contended that it was able to fund all working capital needs out of current earnings. Therefore, the excess funds loaned to SUBSIDIARY were beyond their normal working capital requirements and the interest earned on the investment of such surplus income was nonbusiness income.

TAXPAYER was also denied claims for refund for the year ended 12/31/84 in the amount of $68,213 and for the year ended 12/31/86 in the amount of $57,788 related to the classification of the interest earned from SUBSIDIARY as nonbusiness income.

Additionally, an issue was raised in the 1987-1988 audit related to TAXPAYER' filing of a unitary return with one of its subsidiaries, SUBSIDIARY-2 (hereinafter referred to as "SUBSIDIARY-2"), for the period of 11/1/87 through 12/31/88. The Department removed SUBSIDIARY-2 from the unitary group for the initial two-month period after its acquisition in 1987. TAXPAYER protested said exclusion for 1987.

The issues presented for review are:

1. Whether the Department properly disallowed as nonbusiness income the interest income earned by taxpayer from a loan to its foreign subsidiary for the years ended 12/31/84 through 12/31/88?

2. Whether SUBSIDIARY-2 should have been included in taxpayer's unitary group for 1987 subsequent to its acquisition by taxpayer in October of 1987?

3. Whether adjustments to the property everywhere factor to reflect changes of placed-in-service dates of property should have been correspondingly made to the Illinois property factor for the years ended 12/31/87 and 12/31/88?

[1]Formerly §1050(d)(4).

4. Whether taxpayer should have been given credit for investment tax credits allowed at audit but never re-credited in the amount of $19,528 for the year ended 12/31/88?

5. Whether the Department properly disallowed, as a math error, a negative addition modification to record the inclusion in federal taxable income of an Illinois income tax refund?

6. Whether taxpayer offered evidence of reasonable cause sufficient to abate the Section 1005 penalty proposed in the Notice of Deficiency for the year ended 12/31/87?

After protest and administrative hearing, it is recommended to the Director that the nonbusiness, investment tax credit and negative tax modification issues be resolved in favor of the Department. It is recommended that the SUBSIDIARY-2 unitary inclusion issue, the Section 1005 penalty and property-factor depreciation issues be resolved in favor of taxpayer.

FINDINGS OF FACT:

1. TAXPAYER is a Delaware corporation with its headquarters located in Fort Lee, New Jersey. It is engaged in the manufacture and sale of animal antibiotics and animal feed micronutrients for resale primarily to animal feed producers within the United States. TAXPAYER has a factory located in Chicago Heights, Illinois. (Tr. pp. 113-116; Dept. Ex. No. 36).

2. TAXPAYER was originally organized in 1975 as a wholly-owned subsidiary of PARENT (hereinafter referred to as "PARENT") and was reincorporated in Delaware in September 1983 (Dept. Ex. No. 29).

3. PARENT is a Norwegian parent corporation which is engaged in the manufacture and sale of human pharmaceutical products, food products and agriculture bacterins (for use by fish farmers). (Dept. Ex. No. 36).

4. SUBSIDIARY is a Danish corporation engaged in the wholesale distribution of human pharmaceutical drugs manufactured by PARENT and other unrelated companies in the Danish market. SUBSIDIARY originally was a wholly-

owned subsidiary of PARENT, but in August of 1983 it became a wholly-owned subsidiary of TAXPAYER. (Dept. Ex. No. 36).

5. DANISH is a Danish corporation engaged in the marketing and sale of human pharmaceutical products, human antibiotic products, and human nutritional products in Denmark and other European and third world countries. DANISH was a competitor of PARENT in the Scandinavian countries. (Dept. Ex. No. 36).

6. TAXPAYER acquired SUBSIDIARY, and through SUBSIDIARY, TAXPAYER acquired DANISH. The acquisition of DANISH allowed TAXPAYER to sell its products directly or under license in over 40 countries,but principally in the United States, Denmark, Finland, Norway, Sweden, Holland, the Middle East, Nigeria, Malaysia, Thailand and Indonesia. (Dept. Ex. No. 29, 36; Tr. p. 22).

7. Danish law limited the payment of dividends by a Danish company (DANISH) to a non-Danish shareholder (TAXPAYER). Therefore, the ownership structure was arranged to interpose a Danish company between TAXPAYER and DANISH to hold the stock of DANISH. Consequently, PARENT transferred 100% of the stock of its Danish subsidiary, SUBSIDIARY, to TAXPAYER as a contribution to capital. SUBSIDIARY then acquired DANISH. Since Danish law did not limit the payment of interest by a Danish company to a non-Danish company, the transaction was structured so that DANISH paid SUBSIDIARY dividends and SUBSIDIARY paid TAXPAYER interest on its loan from TAXPAYER. (Dept. Ex. No. 32; Tr. p. 121-22).

8. Danish law required dividends to be declared annually in May or June. The dividend would be declared by DANISH, and as the funds were needed by SUBSIDIARY, the money would be paid on account. Effectively, on the dividend declaration date DANISH had a liability to SUBSIDIARY and SUBSIDIARY had a receivable from DANISH, but the cash was transferred only upon request by SUBSIDIARY. (Tr. p. 137).

9. The acquisition of DANISH by SUBSIDIARY was completed on August 25, 1983 for a total purchase price of $27 million. On or about August 21, 1983, in preparation for the acquisition, PARENT contributed SUBSIDIARY to TAXPAYER. Then, SUBSIDIARY borrowed $20 million from a Norwegian bank and $7 million from

TAXPAYER. The $7 million consisted of a loan from PARENT in the amount of $6 million and a $1 million loan from a New Jersey bank. (Tr. p. 117).

10. Later, in February 1984, TAXPAYER raised $21 million from a public offering of its stock in the United States. The purpose of the public offering was to raise capital to refinance the $21 million of third party loans used to acquire DANISH. TAXPAYER loaned $20 million to SUBSIDIARY to repay the Norwegian bank bridge loan and $1 million was repaid to the New Jersey bank. The original $6 million dollar loan from PARENT to TAXPAYER became a $3 million contribution to TAXPAYER' capital by PARENT and $3 million remained outstanding as a loan. (Dept. Ex. No. 36; Tr. p. 117-20).

12. A technical agreement was entered into by PARENT and TAXPAYER on September 30, 1983 prior to the transfer of SUBSIDIARY and acquisition of DANISH. The agreement was to transfer certain technologies developed by PARENT to TAXPAYER or its subsidiaries for the research, development and production of certain pharmaceutical products for TAXPAYER to use on an exclusive basis in all countries and territories in or constituting part of Europe, Asia and Africa. (Dept. Ex. No. 25). The agreement also required TAXPAYER to use its best efforts to cause DANISH on or before December 31, 1983 to grant, transfer and assign to PARENT all of its right, title and interest in the "Bacitracin Technology." (Dept Ex. No.'s 31,33,34).

12. As a result of the above transaction, TAXPAYER received interest income from SUBSIDIARY on the $20 million loan. (Dept. Ex. No. 36; Tr. p. 16, 24-25).

13. The interest income received from SUBSIDIARY was not segregated from TAXPAYER operating accounts. (Dept. Ex. No. 36; Tr. pp. 49,128).

14. SUBSIDIARY-2 was a corporation located in Baltimore, Maryland engaged in the manufacture and sale of pharmaceutical products to pharmaceutical distributors and retail drug store chains within the United States. Negotiations for its purchase by TAXPAYER began in early 1987 and an agreement

to purchase was entered into in August of 1987. The final closing of the transaction occurred in October 1987. (Taxpayer's Ex. No. 29).

15. During the interim review period, V.P. - Finance of TAXPAYER, and V.P. of Pharmaceutical Operations of TAXPAYER, were actively involved in SUBSIDIARY-2's activities. TAXPAYER had the right to approve or disapprove of any transactions outside the normal course of operations. In addition, TAXPAYER invested more than $5 million in SUBSIDIARY-2 to provide working capital. V.P. OF PHARMACEUTICAL OPERATIONS and V.P. - FINANCE were directly involved in managing SUBSIDIARY-2's cash flow, determining inventory levels, and managing receivables. (Taxpayer Ex. No. 29).

16. On closing, three of TAXPAYER' executives (TAXPAYER'S PRESIDENT & CEO; V.P. OF PHARMACEUTICAL OPERATIONS and V.P. - FINANCE) became directors of SUBSIDIARY-2 and a three person executive committee was appointed to oversee SUBSIDIARY-2's day-to-day operations. (Taxpayer Ex. No. 29, ¶¶ 8-9).

17. Additionally, a subsidiary of TAXPAYER (SUBSIDIARY-3) increased its purchases from SUBSIDIARY-2 after the acquisition. (Taxpayer Ex. No. 29, ¶ 12).

18. TAXPAYER exercised management and control over SUBSIDIARY-2 since its acquisition in October of 1987 in the following manner:

a. TAXPAYER established local banking relationships for SUBSIDIARY-2;

b. TAXPAYER provided centralized administrative services to SUBSIDIARY-2, such as: insurance management, risk management, retirement plan, and employee benefit plan management; and

c. TAXPAYER provided centralized financial and tax reporting. (Taxpayer Ex. No. 29, ¶¶ 13-19).

19. The negative addition modification was incorporated by the auditor in his audit report for the year ended 12/31/88 as a subtraction adjustment. (Dept. Ex. No. 20).

20. The property everywhere denominator was based on the in-service dates on the federal depreciation schedules for the year ended 12/31/87. The auditor attempted to account for fluctuations in property by reflecting actual in-

service dates rather than counting everything evenly during the year. (Tr. pp. 92-100). Also, the auditor used the dates reported on the Illinois Form 1120, Schedule 477 with respect to the numerator of the property factor. (Tr. p. 96). The auditor conceded that an adjustment should have been made to the Illinois numerator with the corresponding in-service dates that were used in the denominator for the same piece of property. (Tr. p. 97).

21. For the 12/31/88 tax year, taxpayer concedes that the auditor calculated the correct amount of investment tax credit. (Tr. p. 145). The auditor allowed the investment tax credit in his report in the amount of $18,808. (Dept. Ex. No. 20).

CONCLUSIONS OF LAW:

1. Nonbusiness Income

Section 1501(a)(1) of the Illinois Income Tax Act defines the term "Business income" as meaning in pertinent part:

> ...income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations...

Section 1501(a)(13) defines "nonbusiness income" as any income other than business income.

In determining whether an item of income is business or nonbusiness income under the definition in Section 1501(a)(1), there are two alternative tests which must be applied. The two separate tests are commonly referred to as the "transactional" and "functional" tests. If either test is met, the income is considered business income, See Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 648 N.E.2d 1089 (1st Dist. 1995); National Realty & Investment Co. v. Department of Revenue, 144 Ill. App. 3d 541, 494 N.E.2d 924 (2nd Dist.

1986). Under the transactional test, income will be classified as business income if it is attributable to a type of business transaction in which the taxpayer regularly engages. The emphasis here is whether the income arises from the "regular course" of the taxpayer's business, and as such, the relevant inquiry looks to the nature of the particular transactions and the forms or practices of the business activity.

Under the functional test, income will be classified as business income if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations. Here, the extraordinary nature or infrequency of the transactions are irrelevant. The focal point, then, is whether the income constitutes an "integral part" of the business activities of the taxpayer.

Section 100.3010(a) of the Department's regulations further provides in pertinent part that:

> ...[a] person's income is business income unless clearly classifiable as nonbusiness income....Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations...

Under the regulations, the critical element in determining whether an item of income is "business income" or "nonbusiness income" is the identification of the transactions and activities which are the elements of a particular business. In general, all transactions and activity which are dependent upon or contribute to the operations of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business.

Taxpayer contends that the interest income from the loan which furnished the funds to acquire DANISH was not income that arose from transactions and activities in the regular course of its trade or business, but that it resulted from an isolated transaction which did not contribute to the operations of taxpayer as a whole.

Additionally, taxpayer contends that funds advanced to SUBSIDIARY were substantially obtained by TAXPAYER from the proceeds of capital contributions

raised through a public offering of stock. The smaller portion of loan proceeds arose from a loan by TAXPAYER' principal stockholder (PARENT) to TAXPAYER and then to SUBSIDIARY. Consequently, taxpayer contends that the substantial portion of the loan proceeds did not arise from business operations, but rather from third party investors. Also the debt service payments on the loan received by TAXPAYER from SUBSIDIARY were used to pay dividends to stockholders and to service the debt to their principal stockholder. As a result, taxpayer argues that the funds were not used for business operations.

Furthermore, taxpayer contends that the acquisition and management of the note receivable which gave rise to the interest income did not constitute an integral part of TAXPAYER' trade or business; it arose out of the public stock offering. The funds arising from the repayment of the loan were used to pay dividends to stockholders. Therefore, the creation and repayment of the loan to SUBSIDIARY was not connected with nor an integral part of TAXPAYER' business; it was totally removed and isolated from TAXPAYER' business operations. Finally taxpayer contends that there was no unitary relationship between TAXPAYER and SUBSIDIARY.

I agree with the Department's position that TAXPAYER' acquisition of SUBSIDIARY and DANISH was not a separate passive investment or an isolated transaction unrelated to TAXPAYER' business operations. Instead, it was a pre-designed initial step in the worldwide expansion of TAXPAYER' existing pharmaceutical business which allowed it to enter the European market and acquire DANISH which was a competitor of its parent in that market.

Although TAXPAYER had always been in the pharmaceutical business with a focus on animal health products and bulk pharmaceuticals, the acquisition of SUBSIDIARY and DANISH created a place in the branded generic pharmaceutical and human nutrition business on the international basis for TAXPAYER. Its Annual Reports reflect that once SUBSIDIARY and DANISH were acquired, TAXPAYER consistently presented itself to its shareholders as an international pharmaceutical business operating in three related biochemical areas (value-

added generic pharmaceuticals, animal health and human nutrition products), all of which were related scientifically and joined by a scientific "common thread" in biochemistry.

Additionally, the acquisition of DANISH gave TAXPAYER international diversity and placement into emerging markets. The restructuring which began with the acquisition of SUBSIDIARY and DANISH continued, during the audit period, with TAXPAYER' acquisition of SUBSIDIARY-3 in 1986 and its 1987 acquisition of SUBSIDIARY-2, both of which were manufacturers or distributors of human pharmaceuticals in the United States. In fact, in its 1987 Annual Report, TAXPAYER stated:

> Thus, beginning with the May, 1986 acquisition of SUBSIDIARY-3 and continuing with the 1987 SUBSIDIARY-2 acquisition, we have established a major branded value-added generic pharmaceutical presence in the United States, within a truly worldwide organization. We believe that our Company distinguishes itself from the U.S. generic drug industry through an important international capability in addition to inclusion of a dynamic animal health business, giving TAXPAYER several of the characteristics that contribute to the strength of most major branded pharmaceutical companies. (1987 Annual Report, p. 4)

The acquisition of DANISH, through the acquisition of SUBSIDIARY, was characterized by TAXPAYER as important since it allowed it to obtain Swiss product registration, thus opening the door for it in previously untapped markets. TAXPAYER viewed the acquisition as an opportunity to strengthen its overall marketing organization in the Nordic countries, to broaden product lines in such countries and to achieve certain marketing efficiencies. In its Prospectus, it was further stated:

> The Company also believes that the technical personnel and experience available through its relationship with PARENT, when combined with the technical resources of DANISH, can facilitate product improvement and manufacturing efficiencies. (Prospectus, p. 21)

On this record, taxpayer relies upon the fact that most of the funds for the acquisition came from third party investors via the public offering rather than from its business operations. Taxpayer's analysis, however, is

unconvincing. The funds were clearly raised by TAXPAYER in the regular course of its business -- through a public stock offering -- to expand its existing operations and as a refinance of its debt. Moreover, the original funds to purchase DANISH came from a Norwegian bank in the amount of $20 million and the remainder of the money came from loans to TAXPAYER as part of its business operations (one loan from PARENT and the other from a New Jersey bank). The utilization of the proceeds from its public offering thus constituted an integral part of TAXPAYER' normal business operations and provided a cash flow to allow for the self-financing of the DANISH acquisition. Clearly, the public offering was nothing more than a sophisticated refinancing of the debt incurred in acquiring DANISH.

I find that TAXPAYER' purpose in acquiring SUBSIDIARY and DANISH was to expand and restructure its own business into other markets and products, and that the acquisition was integrally related to its business operations. Subsequent to the acquisition, neither the loan payments nor the operation of DANISH were separate from or unrelated to TAXPAYER' normal business operations.

Taxpayer also contends that the loan proceeds were used primarily to pay dividends to stockholders and was not a part of its working capital. This was never proven, however, and in fact the record shows otherwise. The proceeds were never segregated from the funds used for working or operating capital. The record is unclear as to whether there was any matching or coordination between dividends and loan payments, in either timing or amounts. Moreover, in its Prospectus, TAXPAYER had represented that while it intended to commence payment of modest cash dividends, the amount of which would depend in part upon its receipt of dividends, interest and/or debt repayments from SUBSIDIARY, most of its earnings would be retained for operations, capital improvements, and business development. Nowhere in the Prospectus did TAXPAYER commit to the payment of dividends from the interest payments. Furthermore, the loan proceeds were managed by CONTROLLER, corporate controller, who was also responsible for

TAXPAYER' other cash management functions. The loan was never intended to be, and never was, a separate and unrelated passive investment.

In addition, DANISH served an operational function to TAXPAYER. There were significant operational relationships between TAXPAYER, DANISH, SUBSIDIARY and PARENT. PARENT sold zinc bacitracin to TAXPAYER and the technology for this was acquired from DANISH in 1983. TAXPAYER distributed polymyxin, a bulk antibiotic products manufactured by DANISH, in the United States. These sales amounted to several million dollars per year in intercompany sales between the two companies. DANISH also performed some manufacturing for PARENT and distributed its products in Europe. SUBSIDIARY distributed some of PARENT's products, and the intercompany sales between those two companies amounted to about $5 million dollars per year.

Furthermore, there were direct loans, loan guarantees, and contributions to capital among the various companies. Also, there were some interlocking officers and directors among TAXPAYER, PARENT, SUBSIDIARY and DANISH, with at least one of taxpayer's officers, President and CEO, becoming involved in some of DANISH's operational activities, such as its negotiation with the Dairy Board.

According to taxpayer, the purpose of the acquisition of DANISH was that PARENT wanted to acquire it. TAXPAYER' involvement, however, was not strictly due to its ability to raise cash via the initial public offering through its access to the U.S. stock market. Clearly, the integral connection between the acquisition of SUBSIDIARY and DANISH by TAXPAYER was a pre-designed and executed strategy of international expansion as shown above.

The acquisitions were not solely to accommodate PARENT. The acquisitions served TAXPAYER in an operational manner because the efficient operation without a competitor and success of PARENT was indispensable to TAXPAYER' business. Even after the initial public offering, PARENT retained 85 percent of the voting power of TAXPAYER' stock. PARENT developed the technology for the manufacture of BMD, one of TAXPAYER' principal products, and held the FDA approval for its

marketing in the United States. TAXPAYER paid PARENT license fees based upon a percentage of all the sales value of its products produced in the United States, including 2.5% of its sales of BMD produced at its Chicago Heights plant.

Additionally, PARENT was continuously providing TAXPAYER with technological assistance and even designed the equipment for TAXPAYER' Chicago Heights plant. Also, a technical support and technologies agreement between TAXPAYER and PARENT was in effect beginning on September 30, 1983 and continuing beyond the audit period. In fact, TAXPAYER' 1984 proxy statement reflects that this technology agreement was entered into in connection with the acquisition of DANISH by TAXPAYER. Furthermore, there were temporary transfers of personnel and PARENT had $5 million of intercompany sales with TAXPAYER.

Taxpayer relies on the proposition that SUBSIDIARY cannot be unitary with it since taxpayer was in the business of manufacturing and selling animal health products whereas SUBSIDIARY was in the business of marketing human pharmaceutical products in Denmark, none of which was manufactured by TAXPAYER. I cannot agree with taxpayer's characterization of its business activities as being limited to animal health products. In one of its own exhibits, V.P.-FINANCE stated that since its formation, TAXPAYER has been engaged in the business of manufacturing and distributing pharmaceutical products. (Taxpayer Ex. No. 29). Moreover, TAXPAYER' position is inconsistent since it files on a unitary basis with other subsidiaries, such as OTHER, SUBSIDIARY-3 and SUBSIDIARY-2, which were all in the business of manufacturing or distributing human pharmaceuticals. In fact, one of the issues TAXPAYER is pursuing in this proceeding is the failure of the department to unitize it with SUBSIDIARY-2 immediately upon acquisition.

More importantly, however, the Illinois Income Tax Act does not require the existence of a unitary relationship between SUBSIDIARY, the payor, and TAXPAYER, the payee, in determining whether the interest income is "business income." Nor is the absence of such a relationship fatal to apportionment of the interest income. See, Allied Signal, Inc. v. Director, 112 S.Ct. 2251 (1992).

The key to determining whether the interest income here can be apportioned as "business income" is whether the transaction upon which the interest income was generated serves an investment rather than an operational function. See, Allied Signal, *id*. at 2263, Container Corp. of America, v. Franchise Tax Board, 103 S. Ct. 2933, 2948, n. 19 (1983). On the record here, the interest income and loan transactions from which it arose had an operational relation to TAXPAYER. The interest income did not arise from an isolated transaction but arose from transactions or activity in the regular course of TAXPAYER' trade or business (transactional test). Also, the acquisition/disposition of the intangible property (note receivable) was not an isolated transaction and constituted an integral part of TAXPAYER' trade or business operations (functional test). Consequently, the Department properly disallowed the reporting of the interest income as nonbusiness income.

II. SUBSIDIARY-2 Unitary Issue

As to the unitary issue regarding SUBSIDIARY-2 for the period 11/1/87 through 12/31/87, the Administrative Law Judge finds that the taxpayer offered sufficient evidence to rebut the Department's determination that SUBSIDIARY-2 was not unitary with TAXPAYER during the first two months after acquisition by TAXPAYER.

Taxpayer offered sufficient evidence to show that the exercise of strong centralized management and functionally integrated operations existed on this record to find that SUBSIDIARY-2 operated as a unitary business with TAXPAYER during said months in addition to the year ended 12/31/88.

Section 1501(a)(27) of the Illinois Income Tax Act defines a "unitary business group" as a "group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other." According to the provisions of 35 ILCS 5/1501(a)(27), unitary business activity can ordinarily be illustrated under a three-step analytical approach. First, for corporations to be considered unitary, 50% or more of the voting stock must be directly or indirectly owned by the parent. The second step is a

determination as to whether the taxpayers are in the same general line of business with each other or are steps in a vertically structured enterprise or process. Lastly, it must be determined whether functional integration exists through the exercise of strong centralized management.

On this record it is clear that SUBSIDIARY-2 was 100% owned by TAXPAYER as of its acquisition date on October 1, 1987, therefore, the first test is satisfied.

Also, the record is clear that TAXPAYER and SUBSIDIARY-2 are engaged in the same line of business: the production of pharmaceuticals. Therefore, the second test has been satisfied in this case.

The remaining phase of the unitary analysis reviews the existence of functional integration through the exercise of strong centralized management.

Section 100.9900(g) of the Department's regulations clarifies the meaning of "strong centralized management" in pertinent part as follows:

> ...no group of persons can be a unitary business group unless they are functionally integrated through the exercise of strong centralized management. It is this exercise of strong centralized management that is the primary indicator of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group. The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member....Both elements of strong centralized management, i.e., strong central management authority and the exercise of that authority through centralized operations, must be present in order for persons to be a unitary business group under IITA Section 1501(a)(27)...

Strong centralized management is determined by a two-step analysis. First, central management authority must exist. Secondly, the taxpayer must exercise this authority to achieve central management functions. Thus, if either party demonstrates that the unitary group as a whole has maintained control over centralized functions such as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment (the significance of the

existence of each of such items dependent upon the facts of the given case), then a finding of the existence of strong centralized management is warranted.

On this record, the Department auditor could not recall the details of the basis of his determination to exclude SUBSIDIARY-2 from the unitary group of TAXPAYER during the initial two month period following acquisition (11/1/87 through 12/31/87). However, he believed that during a short time frame after acquisition of a company, unitary ties could not be developed through strong centralized management sufficient to warrant a unitary finding.

Taxpayer, on the other hand, presented evidence showing the existence of functionally integrating activity and management control from the date of the acquisition. They demonstrated that negotiations to purchase SUBSIDIARY-2 were ongoing since early 1987 and the contract to purchase SUBSIDIARY-2 was entered into in August, two months before its acquisition on October 31, 1987. Between the contract date and the closing date, TAXPAYER was actively involved in SUBSIDIARY-2's activities. TAXPAYER had the right to approve or disapprove of any transactions outside the normal course of operations. Two of TAXPAYER' officers were directly involved in managing SUBSIDIARY-2's cash flow, determining inventory levels, and managing receivables. TAXPAYER also invested more than $5 million in SUBSIDIARY-2 during this period to provide working capital.

Additionally, upon closing, TAXPAYER appointed three directors of SUBSIDIARY-2 and a three member executive committee was appointed to oversee SUBSIDIARY-2's daily operations. Moreover, prior to or immediately after the October closing the following occurred:

1. One of TAXPAYER' subsidiaries increased its purchases from SUBSIDIARY-2;
2. TAXPAYER established local banking relationships for SUBSIDIARY-2;
3. TAXPAYER provided centralized administrative services to SUBSIDIARY-2;
4. TAXPAYER established retirement plans for SUBSIDIARY-2's employees;
5. TAXPAYER had its independent accountants audit SUBSIDIARY-2;

6. TAXPAYER assumed the responsibility for preparation and filing SUBSIDIARY-2's tax returns;

7. SUBSIDIARY-2 was insured under TAXPAYER' policies; and

8. SUBSIDIARY-2 reported all results to TAXPAYER.

Under these circumstances, no post-acquisition time was required to establish a unitary relationship. Moreover, the same or substantially the same factors that were present in 1988 when the Department found SUBSIDIARY-2 to be unitary were present in 1987. On this record, taxpayer has offered sufficient evidence to rebut the Department's prima facie case, and has demonstrated that SUBSIDIARY-2 operated upon acquisition by TAXPAYER in a unitary relationship with TAXPAYER during the year ended 12/31/87. Accordingly, I recommend that the Notice of Deficiency for 1987 must be recomputed to reflect the unitary status of SUBSIDIARY-2.

III. Property Factor - Depreciation

The auditor made reductions to the denominator (everywhere property) of the property factor in TAXPAYER' 1987 and 1988 income tax returns due to the acquisition of certain property. The record showed that the placed in service dates for property acquired during 1987 was uniformly shown on the federal tax depreciation schedules as being 12/31/87 regardless of the actual placed in service dates.

Also, the auditor used the dates which were reported on the Illinois Form 1120, Schedule 477, the actual acquisition dates, for acquisitions of Illinois property in calculating the numerator (Illinois property) of the property factor. The auditor conceded that the adjustments should be made to the numerator and denominator of the property factor on the same basis.

Therefore, I recommend that the Notice of Deficiency must be recomputed to record the adjustments to the Illinois property factor to reflect the same placed in service dates as were used in computing the denominator.

IV. Investment Tax Credit Disallowed

As to the issue of the credit for investment tax credits allowed by the audit for 1988 but never re-credited to the taxpayer, the record has shown that taxpayer is not entitled to a credit in the amount of $19,528.

For calendar year 1988, taxpayer reported investment tax credits of $19,528 but did not include certain supporting documents. Consequently, the Department issued a "math error" adjustment due to this failure and disallowed the credits. Later in the audit, however, these schedules were produced and the credit was allowed in the amount of $18,808.

Taxpayer has received the proper credit for investment tax credits in the audit report for 1988, and therefore, that portion of the Notice of Deficiency is upheld since the credit was given.

V. Negative Tax Modification

The negative tax addition modification issue exists only as to the year ended 12/31/88. Although originally disallowed by the Department as a math error, the auditor reclassified the negative addition modification as a subtraction modification in his audit report.

Consequently, the Notice of Deficiency is correct for the year ended 12/31/88 regarding the subtraction modification in the amount of $135,384.

VI. Section 1005 Penalty

Section 1005 of the Illinois Income Tax Act provides that:

> ...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

As to the issue of the Section 1005 penalty for the year ended 12/31/87, the auditor proposed the subject penalty for underpayment of tax by taxpayer because it was automatically assessed at that time due to the lack of guidelines as to reasonable cause. (Tr. p. 101).

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. see, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

As to the Section 1005 penalty for 1987, taxpayer's position taken on its return as to the interest income from SUBSIDIARY was due to their belief that their facts were analogous to the facts in Section 100.3010(d)(2)(D)[2] of the Department's regulations. Notwithstanding the aforementioned, I do not find that Section 100.3010(d)(2)(D) is on point with the facts of this case. However, taxpayer's position was taken in good faith due to the existence of some of the facts contained in the instant case and the regulations. Consequently, taxpayer has offered reasonable cause to abate the Section 1005 penalty for 1987.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized in part as follows:

1. The amount disallowed as nonbusiness income for interest income paid by SUBSIDIARY to TAXPAYER for the years ended 12/31/85, 12/31/87 and 12/31/88.

2. The Department properly included the reduced investment tax credits for the year ended 12/31/88.

3. The auditor properly incorporated the negative addition modification in his audit report as a subtraction modification for the year ended 12/31/88.

The claims for refund for the years ended 12/31/84 and 12/31/86 are denied based on the discussion of nonbusiness income above.

It is my recommendation that the Notice of Deficiency be disallowed in part for the following:

[2]Formerly §1050(d)(2)(D).

1. SUBSIDIARY-2 should have been included in TAXPAYER' unitary group for 1987.

2. The adjustments to reduce the property everywhere factor to reflect changes of placed in service dates should have correspondingly been made to the Illinois property factor for the years ended 12/31/87 and 12/31/88.

3. The taxpayer has offered sufficient evidence of reasonable cause to abate the section 1005 penalties for the year ended 12/31/87.

Date: _____

Linda K. Cliffel
Administrative Law Judge